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ARGENTINA'S MEDIUM TERM:
PROBLEMS AND PROSPECTS

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INTRODUCTION

This study attempts to provide a global approach to Argentina's medium-term development issues. The first section presents an overview of the main characteristics of the development strategy followed by the country in the post-war period. Emphasis is placed on the role of the state as a locomotive of growth, the characteristics of the investment-saving-financing process and the consequences of the policies implemented on income distribution and on the behavior of the entrepreneurial class. Likewise, the role of both the late 1970's liberalization attempt and the 1975 crisis in generating the present economic situation are examined. The second section, presents the main constraints on growth that Argentina is facing in terms of the saving, external and fiscal gaps and some growth exercises. This section summarizes the results found in Fanelli *et al.* (1989). The third section evaluates medium term development issues at a more disaggregated level. The public, industrial and agricultural sector are then analyzed and there is a brief reference to employment and income distribution. The last section is devoted to conclusions.

SUMMARY

INTRODUCTION

- I. THE PRINCIPAL CHARACTERISTICS OF THE POST-WAR DEVELOPMENT STRATEGY.
- II. MACROECONOMIC CONSTRAINTS AND GROWTH PROJECTIONS.
- III. SECTORAL DISADJUSTMENTS AND GROWTH.
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I THE PRINCIPAL CHARACTERISTICS OF THE POST-WAR DEVELOPMENT STRATEGY

From unstable growth to stagnation, the 1946-1974 period.

The first important feature of the 1946-74 period is that Argentina was able to sustain economic growth relatively well in spite of its inflationary and balance-of-payments problems¹. The performance of the Argentine economy was much better during this period than that observed after the 1975 crisis, even though its growth rate was lower than the impressive ones shown by the most successful countries in the region such as Mexico and Brazil.

During the aforementioned period, the growth rate averaged 3.5 percent per year. Given the relatively low growth rate of the population (around 1.6 percent per year) there was a steady improvement in the per capita GDP of about 2 percent per year. Throughout this period, however, the growth rate showed a wide variance. The higher growth rates were registered in the late forties and the mid sixties. The most stable period from the point of view of growth, on the other hand, was that between 1964 and 1974. During those ten years there was not one year in which the growth rate was negative and it averaged 4.5 percent per year. This rate was similar to that of the first three decades of the present century when the economy experienced its most successful period with regard to growth.

A second feature of the period under analysis was the marked instability that the economy showed in the short run. This instability took the form of recurrent crises in the external sector followed by IMF-inspired stabilization policies designed to restore an equilibrium between domestic

¹ Basic references for this period are Díaz Alejandro (1969) y (1970) and Milton and Sourrouille (1975).

absorption and domestic income. In fact, the prominent role that the balance of payments played in explaining the short-run behavior of the economy was inherent to the development strategy that was chosen.

In effect, while the basic source of growth was the import substitution policy which led to a rapid development of the industrial sector, exports were not growing fast enough to cover the increasing demand for foreign exchange which resulted from the overall growth process. This was so -specially in the immediate post-war period- because the policy stressed import substitution rather than export diversification. Likewise, another factor that contributed to the strengthening of the short-run effects of the cyclical shortage of foreign exchange was the difficulty that Argentina faced in obtaining credit from abroad. In fact, *ex post* foreign saving was not an important source in financing domestic investment and Argentina utilized comparatively much less external financing than Brazil or Mexico in the same period.

Due to these structural features, the behavior of the economy in the short run was well represented by "the stop-and go" model²: as the activity level rose, imports would rise even higher given that the income-elasticity of imports was higher in the short run than in the long one. Because of the short-run rigidity of exports and the scarcity of credit from abroad, the increment in the activity level was brought to a halt by the shortage of foreign exchange. At that stage of the cycle, a stabilization program was usually implemented in order to equilibrate the current account. In this way, even though *ex post* the economy was able to generate both the amount of saving and the foreign exchange necessary for self-sustaining growth, it was achieved at the cost of generating an unstable macroeconomic environment in the short run.

It is worthwhile noting, however, that although it is true that the development policies that

² See Cuatrecasas (1975), Porto (1975) and Díaz Alejandro (1963).

were carried out in the post-war period were unable to fully prevent the countercyclical behavior of the supply of foreign exchange, it is also true that this constraint was weakened over the years. The trade gap was a "much more" binding constraint in the fifties than in the seventies. This was due to the fact that, while imports were effectively substituted throughout this period, other explicit policies designed to diversify exports were adopted in order to correct the anti-trade bias of the import-substitution policies. Consequently, new goods became tradable and long-run forces which helped to equilibrate the current account emerged. As a result, the economy moved from the marked stop-go of the fifties to the more stable growth process of the 1964-1974 period.

Two additional characteristics of the foreign exchange constraint are worth mentioning. In the first place, as was said above, during this period the disequilibrium in the current account stemmed from the propensity of the economy to generate an excess of absorption (i.e. consumption plus investment expenditures) over income. Consequently, the counterpart of the external disequilibrium was a greater overall supply of goods and services on the domestic side of the economy.

This kind of disequilibrium is notably different from the one that the Argentine economy would later suffer throughout the present decade. Today, the disequilibrium in the current account cannot be attributed to the fact that imports of goods and real services are greater than exports. Since the debt crisis, the country has systematically shown a surplus in the goods and real services account. Rather, this disequilibrium exists because the increment in the country's indebtedness induced a structural disequilibrium in the financial services account and, as a consequence, policies intended to maximize the trade surplus were put into practice so as to equilibrate the current account.

A second characteristic of the external gap was that, throughout this period, when the

economy underwent balance-of-payments problems, the stabilization policies that were subsequently implemented were not long lasting because absorption usually adjusted quickly to a level in accordance with the country's income. There was even a propensity to generate an overkill in the adjustment. This characteristic of the stabilization process is completely at variance with what has happened throughout the present decade. The external disequilibrium that is now being experienced cannot be eliminated in a short period of time because it does not stem from a disadjustment between the income and domestic expenditure flows but from the disequilibrium between the flow of income and the stock of debt accumulated. Usually, restoring the balance between stocks and flows takes more time and tends to be more difficult. In fact, during the eighties not only was the Argentine economy unable to revert that disequilibrium but it could not prevent a widening of it.

A third point that should be highlighted with regard to the 1946-74 period is that of the negative consequences of the above-mentioned short-run macroeconomic instability.

This instability took the form of strong variations in effective demand and relative prices in a context of repeated policy shocks. This contributed to the creation of a behavior pattern characterized by a marked risk-aversion in the entrepreneurial class. Consequently, the private sector diversified away from higher risk/long maturity investment projects. Partly as a result of this and in spite of a saving/output ratio of 20 percent, the observed growth rate was not high precisely because of the risk-avoiding pattern followed in allocating the disposable resources for investment.

This conservative conduct on the part of the private sector, in turn, obliged the government to assume responsibility for those investment projects with a low risk-adjusted rate of return that the private sector did not undertake. Accordingly, most of the direct public-sector economic activity encompassed the energy, transport, steel, petrochemical and urban infrastructure sectors. Likewise, for the same reasons (i.e. the instability of the macroeconomic environment), firms tried to insulate

themselves from shocks by seeking institutional agreements with the public sector which would ensure profitability in spite of the repeated occurrence of shocks. The outcome of this was the buildup of a whole structure of market regulations and state interventions which did not frequently consider the resulting effects on both efficiency and income distribution.

So far we have referred to the role played by external constraint and macroeconomic instability in the disequilibria that the economy underwent during the years under analysis. The last feature of this period that should be stressed is the "heterodox" character of the investment-saving process. Indeed, it deserves attention because the way in which the investment was financed induced long-standing effects that greatly contributed to the buildup of the deeper disequilibria that the structure of the economy is now suffering in both the financial and the public sectors.

Throughout the post-war period there was no firm consensus on how much effort each sector of society was to make so as to provide the savings required for financing the income-substitution strategy of development. So, even though ex post the investment level averaged 20 percent of GDP, ex ante there would have been a gap between investment and saving. This would have been the case not so much because of an extreme preference for present consumption but rather because of the uncertainty as to which sector would receive the benefits of austerity. In great measure, this uncertainty stemmed from the abrupt changes in the distribution of income induced by the policy shocks.

Support for the above-stated hypothesis of an ex ante gap between investment and saving can be seen in the way in which the financing of investment was carried out. During this period, a good part of required saving was obtained by means of both forced saving (via manipulation of relative prices) and redistributions of the stocks of financial wealth (regulating prices and/or quantities on the monetary side of the economy).

Several mechanisms were utilized to generate forced saving through variations in relative prices. However, the principal role was played by public policies and the instruments utilized implied a series of manipulations of the absolute prices that were directly or indirectly under the control of the economic authorities: wages, exchange rates and public prices. The changes that were induced in the structure of relative prices produced redistributions of income favoring the accumulation of capital in both the industrial and public sectors. Different sectors were adversely affected by these policies in distinct periods but, in general, the rural sector and low-wages workers tended to be the ones who carried the heaviest burden.

Of the variety of mechanisms employed to generate forced saving through changing relative prices, three can be said to be typical. In the first place, the relationship between internal and external prices was biased so as to shelter the industrial sector. This was done by building up protectionist barriers via tariff and/or imports prohibitions and by taxing agricultural exports. As a consequence of this bias in the terms of trade at the domestic level there was a transfer of incomes from the rural sector to the urban one. It does not necessarily imply that urban workers and the public sector were favored since both of them were obliged to pay more for industrial goods. A second mechanism utilized to generate forced saving was the control of wages (either its level or its rate of growth). A third important mechanism which both operated on flows and redistributed income, was the variety of tax exemptions and subsidies to promote industry. In this way, a system of investment incentives comprised of tax and other exemptions was put into practice. There were several reimbursement regimes for nontraditional exports. Certain imports were exempt from paying tariffs and a "buy national" regime was put into practice³.

Diverse policy instruments were also utilized to redistribute financial wealth so as to favor

³ For a detailed analysis of these mechanisms see Samizadeh, Altirir and Sourrouille (1967).

the sectors which the government sought to promote. Within the financial system these took the form of interest-rate ceilings. Given that this led to an excess demand for credit, the rationing mechanisms that were implemented resulted in a pattern allocation of loanable funds that favored firms to families and industry to other economic activities. These interest-rate ceilings usually induced negative interest rates, resulting in a redistribution of financial wealth from creditors to debtors. Likewise, as the inflation rate was systematically high during this period, the so-called inflationary tax played a significant role in financing public expenditures. Both the negative level of interest rates and the high inflation rates led to the demonetization of the economy. This was so because a saver holding financial assets in his portfolio issued by either the banks or the government would suffer a loss of financial wealth.

A second very important policy-induced redistribution of financial wealth at that time was the retirement and pension system. In effect, given that this system was implemented in the post-war period and first showed a high surplus, the government utilized the funds so generated to partly cover its borrowing requirements. Between 1950 and 1960 the accumulated surplus of the national system of social security amounted to 28 percent of GDP⁴. From the mid seventies on, when the number of retired workers began to grow, the system underwent a structural deficit which was partly offset by downwardly adjusting the level of the transfer payments to retired workers.

The features of the development strategy adopted between the end of the war and the mid-seventies produced an economic structure which tended to generate a variety of almost unmanageable tensions.

In the first place, the public sector was at center stage since it played a crucial role in both generating and allocating resources to investment. This "locomotive of growth" role turned the state

⁴ See Carcobi (1988) and Gerchunoff y Vicens (1988)

into the place where the distributive conflict was resolved and, likewise, obliged it to assume productive activities well beyond its managerial capacity. In the second place, the abrupt and repeated policy shocks which induced significant redistributions of income and financial wealth exacerbated the distributive conflict. As a consequence, the different sectors tried to establish institutional agreements directed to protecting its real income. In particular, a strong oligopolistic sector developed within the sheltered industrial sector which used the "infant industry" argument as a pretext to favor established incumbents over potential entrants. At the same time, so long as the rents generated in the industrial sector were shared by workers in that sector, the trade unions adopted a strong demanding behavior in discussing its participation in those rents. It contributed to the formation of a segmented labor market and a set of select trade unions with strong enough political power to resist policies designed to reduce the rents originating in the oligopolistic sector. In the third place, the financial and monetary policies which induced a segmentation of the financial markets and the demonetization of the economy contributed to the exacerbation of the macroeconomic instability while it also became more difficult to obtain funds for financing both the fiscal deficit and the firm's borrowing needs. Likewise, the negative interest rates produced a reduction of the cost of investment in physical assets in the long run. It is possible that this was why the growth rate was low in spite of the high investment/output ratio. It is worthwhile mentioning that the investment promotion policies also acted similarly in that they favored capital-intensive industries to the detriment of more labor-intensive ones. Finally, given the downward inflexibility of nominal prices -which implies that the changes in relative prices must take the form of a rising level of prices for those goods with improving relative prices- the distributional conflict, the external crises and the industry promotion policies interacted with each other to foster inflation.

To summarize, it follows from what has been said in this section that while the import

substitution strategy succeeded in promoting industrial growth and, to a certain extent, in weakening the foreign exchange constraint, the policies implemented induced severe disequilibria in the financial system, the government budget, the resource allocation, and the distribution of income. Likewise, while the growth rate was acceptable in the long run, it was obtained at the cost of a highly unstable environment in the short run. The deepening of the afore-mentioned disequilibria provoked the economic crises of the mid seventies.

From stagnation to financial squeeze, the 1975-1988 period.

The main features of the 1975 crisis was a fiscal deficit that averaged 15 percent of GDP, a spurt of inflation which led the economy to the brink of hyperinflation and a marked disequilibrium in the current account accompanied by massive capital flight.

During the period following the 1975 crisis (between 1976 and 1981)⁵ a new market-oriented package of policy measures was carried out. It not only attempted to overcome the short-term disequilibria but also to correct the distortions induced by the import substitution policy. The three pillars of the new strategy were the financial and trade reforms and the liberalization of the foreign-exchange market.

Between 1976-78, an orthodox policy closely following IMF recommendations, succeeded in stabilizing the economy. Nonetheless, when the aforementioned reforms were deepened from 1978 on, it resulted in the buildup of the worst economic crisis that Argentina had faced in the post-war period.

⁵ Basic references for this period are Canitrot (1981), Feldmann and Sommer (1983) and Frenkel (1984).

Both the 1975 crisis and the failure of the stabilization attempt of the late seventies induced disturbing effects of long lasting duration. Since the Argentine economy is still suffering from these consequences, there are some characteristics of the 1975-1981 period that are worth mentioning.

In the first place, it should be mentioned that a long lasting consequence of the 1975 spurt of inflation was the consolidation of a high inflation regime⁶. Even though Argentina had previously suffered from chronic inflation, there was a structural change in the level of inflation after 1975. The annual rate of inflation would fall below 100 percent only twice after the 1975 crisis (in 1980 owing to a huge overvaluation of the domestic currency and in 1986 during the Austral plan).

The persistence of high inflation rates over such an extended period contributed to the deepening of the macroeconomic instability that had characterized the evolution of the economy in the post-war period. In effect, given that the surge of inflation produced a widening in the observed oscillation of relative prices, there was a concomitant shortening in the time length of economic contracts. Specifically, wages negotiations in the labor market became more frequent, and, on the financial side, the already scarce supply of medium and long-run loans disappeared. Both facts resulted in a higher level of uncertainty which in turn reflected in the aforementioned increase in short-run macroinstability and the stagnation of the economy in the long run.

The second characteristic of the 1976-81 period that must be highlighted has to do with the puzzling performance of the external sector. For the first time in the post-war period, a succession of disequilibria of opposite signs was observed in the balance of payments in such a short period of time. The final result of those disequilibria, however, was a huge increment of the foreign debt.

Following the expansionary policies implemented in 1973-74, there was a severe imbalance

⁶ On the high inflation regime see Frontal (1989).

in the current account in 1975. However, the economy rapidly overcame this disequilibrium because exports were growing steadily from 1976 on. This was mainly because of a rightward shift in the supply of tradable goods produced by the agricultural sector. As a consequence, the trade gap was not binding between 1976 and 1978. In those three years, the accumulated current account surplus amounted to US\$ 3.6 billion. In great measure this outcome was due to the fact that the stabilization policy implemented between 1976 and 1978 induced an overkill in the adjustment of the economy⁷.

This outstanding performance of the current account, nonetheless, experienced a rapid reversion after 1979. The trade reform and the liberalization of the foreign-exchange market together with a new stabilization program-which in turn led to a huge overvaluation of the domestic currency-were the main causes of the aforementioned reversion. On the one hand, the reduction in the protection level of the economy (via tariff reductions) resulted in a spurt of imports (these were specially finished goods because the level of protection for intermediates had not been changed significantly), on the other, overvaluation of the peso in the context of a higher degree of international capital mobility led to a sharp increase in the outflow of capital.

As a result, from 1979-81 the current account showed a deficit of about US\$ 10 billion. Likewise, capital flight during the same period amounted to US\$ 16.2 billion (around 23 percent of Argentina's GDP). Given that the accumulated current account surplus of the 1976-78 period was insufficient to finance such a large amount of financial outflows, capital flight was financed by increasing the country's indebtedness. The size of the foreign debt rose from US\$ 9.7 billion in 1977 to US\$ 35.7 billion in 1981. Specifically, the government's external liabilities greatly increased.

⁷ See Fazzelli and Frenkel (1985) and Fazzelli, Frenkel and Winograd (1997) where this policy is analyzed together with the concept of overkill.

This means that the financial outflows were in great measure subsidized by the public sector⁸.

Lastly, the deep disarticulation of the financial system is worth mentioning with regard to the liberalization attempt of the late seventies. The narrower dimension of Argentina's credit market would later play a prominent role in constraining the degrees of freedom of the stabilization policies that would be implemented after the 1981 external crisis.

The liberalization of the domestic financial market in 1977 resulted in a rapid reversion of the demonetization process that the economy underwent after 1975. Between 1977-81, the M2/GDP ratio did not reach the level of the previous decade: while during the sixties it averaged 20.5 percent, in 1977-81 it averaged 19.7 percent. In this way, the repressed financial markets of the sixties generated more credit than the freed ones of the 1977-81 period. Likewise, there was not a lengthening of the duration of the financial contracts because of the inability of the financial reform to reduce uncertainty.

Indeed, not only was the financial reform unable to reduce uncertainty but it also generated a financial crash in 1980 which contributed to the widening of the external crisis of 1981. Given that the higher level of financial fragility perceived during 1980 motivated the private agents to substitute foreign financial assets for domestic currency-denominated ones, the financial crisis accelerated the fall in the Central Bank's reserves.

These facts had two long-lasting consequences on the monetary side of the economy. First, there was a dollarization of the private agent's portfolios because of capital flight and the inexistence of foreign exchange controls over an extended period taught the agents to operate in the international financial markets. Second, as the Central Bank acted as a lender of last resort

⁸ For a more detailed account of the process of increasing foreign indebtedness see Fiorilli *et al.* (1987).

during the 1980 financial crisis and on, it grew to be the most important financial institution in intermediating funds in the monetary system. In this way, the monetary authorities turned into a "partner" of the private sector in financing the cost of the financial crash of 1980.

Both the high level of foreign indebtedness which resulted from the failure of the liberalization attempt and the long lasting effects of the exhaustion of the post-war growth strategy since 1975 revert in a structural disequilibrium in the external and the public sectors. As a consequence, throughout the eighties the Argentine economy would show its worst performance in the whole post-war period. Between 1981 and 1988, inflation averaged 166.2 percent per year; the average growth rate was slightly negative; the fiscal deficit/GDP ratio was more than 10 percent and the foreign debt rose from US\$ 35.6 billion to US\$ 58.7 billion.

In the following section, we will analyze the present situation and the prospects of the economy in terms of the external, fiscal and saving gaps. Before that, however, it is worthwhile stressing that during the eighties, the evolution of key macroeconomic variables has shown an explosive trend which, in turn, exacerbated the short-run instability of the economy which had been observed throughout the post-war period. In effect, in the first place, even though the accumulated trade surplus between 1981 and 1988 was US\$ 20.1 billion, the current account deficit was US\$ 22.8 billion. That is, in a period eight years, the transfer of resources abroad was about a third of Argentina's GDP. In spite of this, the foreign debt grew just as much. Given the domestic product's stagnation, the debt/output ratio tended to grow explosively. In the second place, while the public deficit increased as a consequence of the servicing of the foreign government debt, the dollarization of the economy deepened (i.e. there was a fall in the demand for domestic assets). Accordingly, the relationship between the government deficit and the demand for domestic assets shifted upward. This has given rise to strong destabilizing forces such as increasing financial fragility and attempts

to reduce the fiscal deficit in a disruptive way from the point of view of growth (i.e. reducing public investment below the minimum required to preserve the stock of capital). Finally, as a consequence of policy shocks which took the form of massive devaluations and disproportionate increases in public prices, the high inflation regime tended to become hyperinflationary.

II. MACROECONOMIC CONSTRAINTS AND GROWTH PROJECTIONS⁹

The purpose of this section is two-fold. Firstly it intends to analyze the main factors determining the behavior of the economy in terms of the fiscal, domestic and external gaps. Secondly, it describes some growth exercises for the Argentine economy under alternative scenarios.

From what has been said in the previous section, it follows that the huge increment in Argentina's indebtedness was the counterpart of massive capital flight rather than of excessive domestic absorption. Therefore, the counterpart of the increased level of liabilities was not a broadening of production capacity but rather the increment of external assets held by the private sector. Since the process of capital flight was largely financed, directly or indirectly, by the public sector, today, the government holds most of the external debt (i.e. almost 90 percent of it).

There have been four important consequences. In the first place, there has been a permanent change in the relationship between GDP and GNP. The GNP/GDP ratio fell from 98,7 percent in the seventies to 91,9 percent in the eighties. This was almost entirely due to the heavy burden imposed by the servicing of the external debt. In the second place, as a result of the increase in interest payments abroad the current account has shown a permanent deficit since the

⁹ This section summarizes the main results of Fiszell *et al.* (1989).

early eighties. In the third place, as the debt is mainly public, the external crisis has taken the form of a fiscal one. Finally, the increase in the fiscal deficit has had disturbing effects on the financial side of the economy. These facts have significantly changed the features of the external, fiscal and saving gaps.

Let us begin with the saving gap. This gap may be interpreted as a measure of the disequilibrium between investment and saving at an aggregate level; therefore, it is important to examine the investment and saving data. With regard to saving, it must be said that the main aggregated agents (the government, the rest of the world and the private sector) greatly changed their behavior during the adjustment period of the eighties as compared to the seventies: while both private and government savings dropped sharply, external savings rose markedly. In the previous decade government savings averaged 1.9 percent of GDP; those of the private sector averaged 19.2 percent; and the external sector provided funds for about 0.6 percent of GDP. After the debt crisis, during the eighties, the saving/GDP ratios for the government, the private sector and the external sector were -3.4 percent, 13.2 percent and 4.3 percent, respectively.

The investment/GDP ratio has also fallen heavily during the eighties. Historically, the above-mentioned ratio was around 20 percent; after the crisis the share of investment in GDP averaged 14 percent. There are several explanations for the downward trend in investment. One of the most important of these being that when public sector expenditures increased because of the increment in external debt service payments, the government attempted to reduce public expenditures. Of these, investment expenditures was the most reduced. In turn, as there is a complementarity between public and private investment, the latter dropped as a result of the former's reduction. Fluctuations in relative prices, high interest rates (both in the domestic economy and abroad), and deceleration effects were also causes of the downward trend in the investment/GDP ratio.

The ex post evolution of investment and savings suggests that the saving constraint might become a binding one when Argentina attempts to resume growth. There are at least two reasons for this. Firstly, while the saving/GDP ratio fell by 53.3 percent after the crisis, the fall in the investment/GDP ratio was lower: 34.5 percent. Secondly, the increment in foreign saving which closes the gap between internal saving and investment was not voluntarily provided by the rest of the world. In fact, Argentina was able to utilize external saving mainly because of its arrears in foreign payments.

When the saving gap is binding: (1) there is a positive relationship between the availability of financing from abroad and growth, (2) the larger both the marginal propensity to save and the tax burden is, the larger is the rate of growth, (3) if there is an increase in public expenditures, there will be a fall in the rate of growth. This implies that the rate of growth of the economy is a function of the fiscal policy parameters, the saving behavior of the private sector and a set of domestic and foreign financial variables. As we said previously, all these factors showed important changes after the debt crisis. It should be added that available data suggest that the private sector did not dramatically change its propensity to save. Therefore, the fall in the saving/output ratio would have been caused mainly by two factors: the increment in foreign payments (i.e. the downward trend in national income) and the denationalization of domestic saving that took the form of capital flight. The overinvoicing of imports and the underinvoicing of exports were the main mechanisms used to send capital abroad.

The increment in the interest payments also influenced government saving. In the 1975-80 period the government's total internal and external interest payments were 2.56 percent of the potential output while in the last year it amounted to 5.3 percent. The ex post value of external saving, on the other hand, rose during the eighties by about 4 percent of the potential output.

According to the calculations made by Fanelli *et al.* (1989) taking into account the 1988 value of the variables, the growth rate of the potential output permitted by the saving gap would be 0.46 percent per year. Given the available external financing, however, if the interest payments had been similar to its average value in the 1976-80 period, the growth rate of the potential output for 1988 could have been 3.3 percent without opening the saving gap. This gives us an idea of the effects of the crisis on the saving gap and shows that today the saving constraint is "more binding". It means that Argentina must lower consumption at each level of the potential output before it can begin to resume growth. It also implies that transfers abroad should be reduced. However, in order to have a complete picture of the constraints to growth that Argentina is facing, we must take into account the other gaps.

As we have said before, even though the trade gap placed a severe constraint upon the growth rate during the post-war period, the character of this gap changed after the debt crisis. While the deficit in the current account stemmed from a deficit in the trade balance before the debt crisis, today's deficit in the current account originated in the financial services account. Consequently, in the absence of "fresh" money, the country should maintain a continuous surplus in the trade account. This surplus should be as large as the deficit in the financial services account. Accordingly, this implies that domestic absorption should be continuously lower than the domestic product. In fact, although Argentina received some fresh money between 1981 and 1987, the country has maintained a permanent surplus in the trade account of about 3 percent of GDP. This has not only served to depress investment but has also reduced consumption and employment as well.

Given the structural characteristics of the Argentine economy, there is a sharp trade-off between growth and capacity utilization when the trade gap becomes a binding constraint. Given

the availability of foreign exchange, higher-capacity utilization and therefore higher intermediate imports mean lower imports of capital goods. This implies that both investment and, consequently, the growth rate must fall. For the same reasons, there would be an increment in the growth rate if there was an increment in the amount of net capital inflows; a rise in the share of exports in the potential output or a decline in foreign payments.

After 1980-81, the principal modification in the variables determining the behavior of the external gap was the increment in foreign payments. This explains the fall in the potential output growth rate.

Two additional points must be highlighted with regard to the trade gap. In the first place, the share of exports in the potential output showed an upward trend during the adjustment period. Given the downward trend in the terms of trade that Argentina faced, however, the larger quantities of exports did not induce an increase in the value of exports proportional to the increment in the quantities supplied. Between 1980 and 1988 the export volume increased by 46 percent but the value of exports changed only slightly because of a 35 percent deterioration in the terms of trade. In the second place, the deindustrialization process induced by the liberalization policy of the late seventies has induced some reversal in the import substitution process underway since World War II.

The effects of the increment in foreign payments on the potential growth rate can be seen by comparing the resulting growth rate when using the average values of the capital inflows/output and foreign interest payments/output ratios for the period 1975-80 (0.59 percent and 0.56 percent respectively) with the rate that is obtained when using the values for those variables in 1988 (3.6 percent and 5.4 percent respectively). In the first case, according to Funelli *et al.*, we would obtain a growth rate of 4.4 percent while in the second it would be one of 0.46 percent.

The effects of the debt crisis on the fiscal-financial gap are also very significant. The most important restriction on growth has been imposed by the domestic transfer problem. The core of this issue is that while the government has to pay the interests on the foreign debt, the private sector "owns" the surplus of the trade account which provides the foreign exchange necessary for the payments on the interest due. In other words, the public sector must buy the external surplus from the private sector and the government must obtain the funds to do so by either reducing its expenditures or raising taxes. Both of these measures tend to depress the activity level and to restrain growth. If neither expenditures nor taxes are modified, *ceteris paribus* the fiscal deficit is higher and must be financed by either issuing money or placing more public debt within the private sector. With the former, the government loses control over the stock of money; with the latter, the interest rate tends to rise and investment is further depressed. In addition, neither of these alternatives can be maintained in the long run since they imply growth rates of financial assets inconsistent with a reasonable ratio between financial assets and GDP (i.e. for the equilibrium in the financial markets to be sustainable in the long run, the growth rate of GDP and financial assets must be roughly the same, and this is not the present case). In fact, Argentina's recent experience has shown that the dollarization process that the economy has been undergoing since the 1980 financial crisis tends to accelerate when there is an increase in the issue of domestic financial assets. That is, domestically generated savings goes abroad instead of financing investment within the country.

In this way, when the government budget constraint is integrated into the analysis, it becomes clear that if Argentina resumes self-sustained growth it will face a kind of "knife edge" growth path from the fiscal point of view. While a fiscal reform to increase government's saving is a necessary condition for growth, the subsequent increase in the tax burden (and/or the decrease

in expenditures) should be designed so as to prevent possibly depressing effects on the "animal spirits" of the private sector¹⁰.

The need for a structural reform in the public sector can be illustrated quantitatively with the following example. If the policy variables that define public sector saving are unchanged, the only "endogenous" variables that would allow for an increment in public sector investment would be the output level (a rising income implies increasing government's revenues) and the fiscal deficit. In such a situation, ceteris paribus, for the growth rate to rise by one percent, either the activity level should increase by 10.9 percent of the potential output or the fiscal deficit should be reduced by 2.5 percent in relation to the same variable. Given that capacity utilization is restricted to being under 100 percent, the first alternative would only be feasible if the economy were experiencing a vast recession. Likewise, as we shall discuss later, the second alternative might not be feasible because of the disturbing effects of placing more debt in the asset markets in order to finance the fiscal deficit.

The previous analysis of the three gaps has shown the main factors that have determined the long-term deterioration of Argentina's economic position. The simulations of the performance of the economy in the future show that if the destabilizing forces at work in the external and the public sectors are not deactivated, the deterioration will continue. For an idea of both what would happen if the status quo were maintained and the minimum conditions for resuming growth, we will briefly describe the main features of the status quo and the 3 percent annual growth rate scenarios simulated in Fanelli et al. (1989).

Let us begin with the analysis of the status quo. It is assumed that: (1) there is no change in the structural parameters which define the three gaps; (2) the capacity level is maintained at the

¹⁰ For a discussion of the incentives issue see Frenkel and Ruiz-Ortega (1988).

1988 level; (3) exports will grow at a rate of 3 percent per year (which is similar to the 1980s observed rate).

Table 1 shows the evolution of the above-mentioned endogenous variables from 1988 to the year 2000. Note, in the first place, that this scenario very closely reproduces the principal patterns of behavior that the economy has shown since the debt crisis: a continuous fall in the investment/potential-output ratio, a low or negative rate of growth and an upward trend in both the internal and external debt. In the second place, the projection clearly shows the long-run consequences of the public sector financial squeeze. Due to the upward trend of both foreign and domestic-debt ratios, the proportion of interest payments in public spending shows a permanent increase over time. Since the capacity utilization is given, the public sector revenue ratio lags behind the increment in the interest due on the outstanding debt. Therefore, public saving tends to reduce its share in the potential output and public investment adjusts accordingly. In the third place, due to both the reduced (or negative) growth rate and the constancy of the capacity utilization ratio, neither intermediate nor capital good imports increase. As a consequence, given the steady growth in the exports ratio, foreign saving tends to decrease in order to meet the external constraint. In fact, there is a current account surplus after 1997. In other words, there is a negative trade-off between growth and capacity utilization on the one hand, and the requirements of external financing on the other. Finally, note the explosive evolution of domestic government debt, which illustrates the long-run consequences of the previously mentioned domestic-transfer problem. The upward trend in the public sector's interest payments results in a positive deficit in spite of the reduction in government investment. Therefore, the fiscal deficit is systematically positive over the period and an explosive trend in the domestic debt results from the accumulation of the public sector borrowing requirements of each period over time.

Table 2 shows the evolution of key macroeconomic variables required to maintain a 3 percent growth rate. In order that such a growth rate be achieved, it would be necessary to induce a significant jump in the investment/potential-output ratio. This means that both overall saving and the investment ratio of the public sector should increase accordingly. Moreover, since we have assumed full capacity utilization and a higher growth rate, imports would be increasing. Therefore, it should be necessary to induce an increase in the share of the rest of the world's saving in the potential output in order to meet the external balance constraint. However, overtime the required amount of foreign saving declines *pari passu* with the increment in the export's share.

With regard to the financial side of the economy, the projection shows that if the economy were growing at 3 percent per year, the evolution of the stock of public debt would not be explosive as was the case in the *status quo* scenario. Neither the government external nor internal debt shows a steady upward trend.

However, a 3 percent growth rate target requires a strong adjustment in the public sector's policy parameters so as to raise government saving. Otherwise, there would be a considerable gap of about 7 percent of the potential output between the existent public sector savings and that required at the beginning of the program. If this gap is not closed, obviously, it would render the growth target unfeasible. With regard to this, however, it is worthwhile noting that the public sector's saving requirements would be less if: (1) there were a reversal in the process of denationalization of saving in that this would signify an increase in the private sector's rate of saving; (2) there were an autonomous increase either in the private sector investment demand or in the efficiency of the economy (i.e. a lower capital/output ratio) because the same growth rate could be then achieved with a lower level of public investment.

III. SECTORAL DISADJUSTMENTS AND GROWTH

In the previous section we emphasized the constraints that macroeconomic consistency put on growth. We will now analyze at a more disaggregated level other factors that are important in constraining growth in the present situation as well as the reforms that should be put into practice in key sectors.

The public sector.¹¹

As we have said previously, although the difficulties that the public sector faced worsened in the 1980's, the development strategy that was followed during the post-war period created serious disequilibria well before the present decade. In great measure, the lack of flexibility in adapting taxes and expenditures after the debt crisis was a direct consequence of the inertial behavior of the main fiscal variables. The evolution of such variables greatly depended on certain structural characteristics of the public sector and on the existing legislation such as that concerning industrial promotion and the investment incentive regime.¹²

It should be taken into account that the public expenditures/output ratio was increasing before the debt crisis. While income stagnated in the late seventies, public sector expenditures maintained the rate of growth that it had experienced throughout the post-war period. Accordingly,

¹¹ For a detailed analysis of the public sector in Argentina see Gerchunoff and Vicuna (1989), Careoni (1988) and Programa de Asistencia Técnica para la Gestión del Sector Público (1989).

¹² The most important laws with regard to this are analyzed in Arpiazza (1988).

the government expenditures/GDP ratio rose from 25 percent in the early seventies to 38 percent in the early eighties.

Throughout the 1980's, the aforementioned ratio showed a declining trend as a consequence of the successive stabilization plans. In 1987-88 it averaged 31 percent. This result was obtained, however, with very distortive consequences, mainly because the kind of expenditures that were reduced were not determined by efficiency or equity considerations.

The principal budgetary items that determine the evolution of Argentina's public sector expenditures are wage and social security payments, interest on public debt, the deficit of public enterprises, and overall government investment¹³. Wages and investment have carried the burden of the public sector adjustment for two significant reasons. First the authorities cannot exert control over the amount of interests due; and second, public enterprises underwent severe budgetary difficulties (mainly because of their huge foreign indebtedness). Wages were adjusted by depressing its real level (in order to minimize the consequences on employment) while the public investment/output ratio, fell from 12 percent in the late seventies to less than 7 percent in 1988.

This reduction in public expenditures, nonetheless, was insufficient to close the fiscal gap. Government public revenues in the best years reached 28 percent of GDP (including social security revenues) and averaged 25 percent in the adjustment period. The distortion in the tax structure as well as severe shortcomings in the tax administration process prevented an increase of the tax burden *pari passu* with the increment in foreign payments¹⁴.

One of the most important ways in which the tax structure impeded a rise in the tax burden

¹³ The participation in total public expenditures (as percentages of GDP) are: wages: 9.4 percent, social security: 9.5 percent; interest: 2.4 percent and investment: 6.9 percent. The deficit of public enterprises fluctuates between 0 and 2 percent, but is important in the margin.

¹⁴ For a detailed analysis of the tax structure see Programa de Asistencia Técnica para la Gestión del Sector Público (1989).

was the erosion of the tax base which affected both direct and indirect taxes.

The amount of direct tax collected was practically nil (it amounted to less than 1 percent of GDP). First, because of the denationalization of part of the private sector's wealth as a result of capital flight; second, because of the legislative weaknesses concerning tax on profits¹⁵; and third, because of authorized tax deferments and exemptions by the investment incentive regime. In this way, the greatest source of tax collecting came from the indirect ones: value added, and taxes on fuel and international trade¹⁶.

In the case of indirect taxes, however, the erosion of the tax base was also a serious impediment to obtaining a permanent increase in the amount collected, regardless of equity considerations. On the one hand, the base of the value added tax was severely narrowed because of the preexisting legislation regarding industrial promotion (both sectoral and regional). This was so because the regime was based on value added and other tax exemptions¹⁷. On the other hand, the size of the base of taxes on international trade has shown a fluctuating evolution -specially with regard to taxes on agricultural exports- due to both the erratic behavior of the terms of trade and the instability of the activity level.

One consequence of all this was the wide use of the fuel tax as an instrument to raise the government's revenue. The policy of offsetting lower tax collecting by means of increasing this tax was a very important cause of the increased macroeconomic instability. It contributed to the acceleration of inflation and also to the worsening of the distortions in relative prices¹⁸.

¹⁵ Specially with regard to the calculation of benefits after the inflation-adjustment of balances.

¹⁶ Value added represents 24.5 percent of total tax collecting while the participations of fuel, foreign trade and profit taxes are respectively 16.7 percent, 18.2 percent and 8.9 percent.

¹⁷ The fiscal cost of tax expenditures is about 3.4 percent of GDP see Artana (1989).

¹⁸ The attempts to close the fiscal gap by increasing the prices of public enterprises (oster inflation as well.

It should be added that macroeconomic instability in itself was an autonomous factor in narrowing the tax base. The Olivera-Tanzi effect¹⁹ and the increase in fiscal evasion were the principal factors. The former was important because of the acceleration of inflation after 1975; the latter widened after the debt crisis *pari passu* with the dollarization of the economy and the administrative difficulties in the public sector.

The erosion of the base, tax evasion and the Olivera-Tanzi effect have induced a reduction in tax collecting of more than 10 percent of GDP (by conservative estimates)²⁰. This amount is similar to the average size of the fiscal deficit experienced during the 1990's.

In the previous section we have seen that a fiscal reform is necessary because of the significant increment in the savings of the public sector required for a 3 percent growth rate. So, the factors impeding an increment in government revenues must be removed. Specifically, tax evasion must be reduced by means of improving tax administration and at the same time, legislation concerning industrial promotion and investment incentives must be severely restricted since the public sector cannot bear the implicit fiscal cost. However, complete success cannot be obtained without stabilizing the economy as the widening of the underground economy and the high inflation regime are the basic causes of the fall in tax collecting.

With regard to expenditures, as was seen in the growth exercises, the improvement of the performance of public investment is a necessary condition. It is a difficult task because there must be an efficient allocation of investment funds given the extreme resources constraint yet, there is a series of obstacles that make it very difficult to design a feasible medium-term public investment program.

¹⁹ Steeb and Domper (1987) calculate that this effect represented around 2.5 percent of GDP.

²⁰ See Programa de Asistencia Técnica para la Gestión del Sector Público (1989).

There are many factors that impede an efficient allocation of public investment. In the first place, existent legislation regarding public works in many areas induces a lack of flexibility in the investment decision-making mechanism. With regard to this, earmarked funds for energy and transport sectors are very important. At the same time, the "buy national" system makes it difficult for the public sector to optimize the allocation of funds. In fact, they are frequently used as a way to reallocate funds from investment to subsidies benefitting the private sector. In the second place, there are costly projects initiated under optimistic assumptions on the future growth of the economy that the debt-crisis has rendered unprofitable. It is very difficult to discontinue those projects because of sunk cost and the high cost of cancellation. Finally, vested interests are very active in impeding the reallocation of resources to higher priority areas. It should be taken into account that the state is the most important client of 20 of the 100 leading firms of the economy (ranked by sales)²¹.

Notwithstanding, the priorities of public investment should be: first, the maintenance of an infrastructure that prevents further quality deterioration, specially in urban services, health, education and transport. It should be stressed that during the last years public investment has hardly covered the depreciation of the stock of capital in many of those areas. Second, private sector participation should be allowed in those activities that the public sector can no longer cover because of a lack of resources²². Third, there should be a concentration of net investment in cases of a suboptimal resource use (such as oil and gas exploitation) and in order to overcome bottlenecks (pipelines, ports, power distribution). Fourth, given the regressive income distribution which resulted from the adjustment period, resources should be allocated to improve social services.

²¹ See Koskoff (1988).

²² It should be taken into account, however, that privatization is not an easy task. With regard to this see Weinek (1989).

Industry and rural sectors.

As was said in the first section, the import-substitution strategy and the policies implemented by the government during the post-war period, greatly privileged industry. As a consequence, the growth process was led by the industry with the consequential increase in its participation in the domestic product. The liberalization attempt of the late seventies, however, brought this process to a halt. The industrial product/GDP ratio fell from 28 percent in 1975 to 22 percent in 1982 and fluctuated during the following adjustment period around this level. In 1988, it was 22.6 percent²³.

The deindustrialization process that followed the debt-crisis, however, affected distinct sectors within industry in varying ways. Metal products and electrical machinery were most adversely affected. Other sectors, such as the food, aluminum and petrochemical industries maintained the previously reached level of development. Traditional sectors like the oil and leather industries showed an acceptable evolution, especially regarding exports. In fact, the industries that suffered the greatest deterioration were those which were technologically more complex. A consequence of this was a reduction in the employment of skilled workers and an increment in the demand for unskilled ones even though the industrial employment level remained unchanged.

The concomitance of the deindustrialization process and the lack of a consistent pattern in designing the industrial policy (specially regarding the trade and investment regimes and industrial promotion)²⁴ resulted in the many distortions that the industrial structure is now showing. So, a

²³ For a study of the interaction between the macroeconomic evolution of the economy and industry see Kosakoff (1988).

²⁴ The consequences of the industrial promotion, on the industrial structure are evaluated in Argüez (1988).

growth-oriented policy must necessarily address the reform of the industrial sector. Several distortions now constraining industry development should be eliminated.

In the first place, there is a bias toward activities characterized by high capital intensity and low value added. This is a direct consequence of the existing regimes of incentives which tend to favor investment to the detriment of employment. Tax deferrals and exemptions from taxable profits and from imported capital goods contribute to this. In the second place, heavy intermediates have received a disproportionate amount of benefits. So, petrochemicals and chemicals, ferrous metals and cellulose have increased their participation in the industrial product to the detriment of other sectors. This is a consequence of the sectoral-incentive regime which has also concentrated the allocation of incentive funds within a reduced group of no more than fifty projects which are highly capital intensive. In the third place, there is a regional bias induced by the regional-promotion regime. This regime has not only distorted the localization of industries but has also favored assembly industries to the detriment of others using highly skilled workers.

In the fourth place, there has been a process of industry concentration favored by the incentive regime, the protection barriers and the financial crisis. The latter fosters the concentration process insofar as the firms with a hedge financial position were able to purchase at "bargain prices" those that were affected by the lack of credit and the high interest rates experienced by the economy after 1980-81²⁵. Finally, the government buying system must be changed in order to improve its efficiency and reduce the effects on the fiscal deficit of the higher prices that the public sector must pay as a consequence of the "buy national" regime.

The severe restraint experienced by domestic effective demand has been one of the

²⁵ Dami and Fatelli (1988) analyzed the balance sheet of the 122 largest firms in the industrial sector and found that they invested heavily in buying small firms undergoing financial problems.

prominent factors that contributed to industry stagnation. In fact, the regressive income distribution that resulted from the adjustment period following the 1975 crisis explains in great measure the retraction of effective demand. The sharp drop in the investment/output ratio after the debt-crisis constituted a second important reason why the effective demand was pushed downward.

Given the present prospects for the probable evolution of the economy, a rapid recovery of the domestic components of effective demand cannot be expected. Therefore, exports should be privileged as a source of demand for industry. It implies that important changes in the incentive regimes should be made in order to correct the aforementioned bias which has prevented a rapid increment in Argentina's industrial exports.

Although rural sector production represents only 15 percent of GDP, it plays a fundamental role in the Argentine economy with regard to both short-run stability and growth. In effect, (a) land-and-cattle production is the main source of foreign exchange (60 percent of total exports originates in this sector); (b) the goods produced by the sector represents 15 percent of the amount of the consumer's basket; (c) it contributes significantly to government revenues (although its overall contribution tends to fluctuate widely in the short run)²⁶.

The most hitherto important feature with regard to this sector was the evolution of agriculture from 1975 on which was completely at variance with that of industry: while industry stagnated the agricultural production showed a marked upward trend. This can be seen in the annual growth rates of the production of wheat and oilseeds: they were 0.5 percent and 2.4 percent respectively between 1960 and 1970; 3.1 percent and 12.2 percent in the 1970-80 period and 7.5 percent and 12.2 percent between 1980 and 1985. This outstanding evolution by agriculture was mainly a consequence of a deep technological change in both oil cultivation and in the organization

²⁶ For an exhaustive study of the rural sector's present situation and prospects see Isauri (1983). See also Carrasco *et al.* (1988).

of work, specially in the Pampa Húmeda region²⁷. The positive evolution of productivity in agriculture tended to displace cattle production and, as a result, the latter lost importance in explaining the evolution of exports from the rural sector. Likewise, there was a displacement of cattle production to less productive land.

According to specialists²⁸, the prospects of the future evolution of this sector, specially with regard to agriculture, seems to be promising. However, in great measure, it will be conditioned by the overall evolution of the economy. Two factors should be stressed. Firstly, the sharp drop in the public investment in infrastructure (railways, roads, ports and storage systems) has generated a series of difficulties in this sector. These difficulties will worsen in the future if the upward trend in crop production is maintained. Secondly, the reduced supply of credit has put a severe liquidity constraint on this sector's evolution. So, stopping the demonetization of the economy and increasing public sector investment would greatly benefit rural production.

The external sector.

Given that the trade gap is a tight constraint on growth, the future performance of exports will play an important role in determining the growth path of the economy.

During the import-substitution period, the growing industrial sector increased its participation in exports. The participation of industrial exports grew from 3 percent in 1960 to 24 percent in 1975. Afterwards, however, this process of growth stagnated. In 1988 the share of

²⁷ For an overview of the factors that helped to increase productivity see Barsky (1989).

²⁸ See Barsky (1989).

industry in total exports was 23.5 percent. Likewise, the structural changes that took place in industry after the debt crisis have had consequences on the kind of goods exported. As machinery lost influence, industrial goods originating in the primary sector and heavy intermediates with low value added augmented their participation. The participation of the latter in industrial exports, on the other hand, showed a countercyclical behavior since firms tended to offset the short term decrease in domestic demand by selling abroad²⁹.

Rural exports have shown a steadily upward trend, specially as a consequence of the aforementioned increment in agricultural productivity. Accordingly, Argentina's grain exports increased from 8.9 millions of tons in 1970 to 15.6 millions in 1980 and 20.5 in 1985. Following that, there was a decline because of bad weather conditions, but now exports are improving again. The projections on the future performance of both grain and cattle exports are optimistic³⁰. However, it should be stressed that the future evolution of Argentina's exports depends heavily on Northern agricultural policy. Over the last years, European and U.S. agricultural subsidies have depressed prices there by worsening Argentine terms of trade. With regard to this, a certain degree of success in the negotiation within GATT is of importance.

Even though the country must improve the growth rate of exports, it should not try to maximize the trade account. The result of such an strategy would only revert in an accelerated amortization of foreign debt. It would not provide a solution to the macroeconomic disequilibria that the country is undergoing. In fact, if the private sector leads the process of export's growth, the domestic transfer problem would worsen. So, the growth strategy should be able to both reach a reasonable long-run agreement with foreign creditors and to induce an increment in imports in

²⁹ The evolution of industrial exports is analyzed in detail in Aspizua *et al.* (1994).

³⁰ See Basky (1989).

accordance with an improvement in exports.

A trade reform is necessary in order to prevent a non-intended maximization of the trade surplus. It should be aimed at significantly reducing the level of domestic production protection. However, given the disappointing results of the trade reform of the late seventies, the import liberalization should be carefully implemented. Specifically, it should avoid the two more distortive features of the aforementioned reform: it should not be too fast and it should prevent the reduction in the protection of finished goods while maintaining a pre-trade reform shelter for the intermediate producers.

Employment and income distribution.³¹

During the adjustment period, macroeconomic instability induced significant fluctuations in the labor market. However, in the long run, in spite of output stagnation, there was a slight upward trend in employment and the increment in unemployment was not dramatic. This fact is surprising, especially when compared with what has happened in other regional countries that have undergone severe economic crises during the eighties.

The above-mentioned evolution of employment is explained by various factors. In the first place, there was an increment in underemployment. It rose from 4.5 percent of the labor force in 1980 to 7.8 percent in 1988. In the second place, there was a reduction in the economy's average productivity as a consequence of the deindustrialization process which was accompanied by an increasing trend in the service's participation in the total output. While, 29.7 percent of the total

³¹ Danalt (1989), and Becerra (1989) intensively analyze these topics

labor force was employed in industry in 1980, that proportion had fallen to 26.6 percent in 1988. Finally, the size of the supply of labor tended to vary procyclically during the adjustment period. This helped to offset the effects of the activity level's fluctuations on observed unemployment. After a significant jump at the beginning of the debt crisis (it rose from 2.6 percent in 1980 to 6 percent in 1982), it has oscillated between 4.5 percent and 6.5 percent.

Even though there are no available official data on income distribution, the estimations that have been made suggest that there was a structural change in the income-distribution pattern since the import substitution development strategy crisis in 1975. In effect, while workers achieved the highest participation in domestic income in 1974-75, after the crisis the income distribution worsened acutely. Worker's participation fell from 43.4 percent of GDP in 1975 to 27.9 percent in 1976, and afterwards averaged 30 percent in the liberalization period of 1976-1980. The debt crisis, on the other hand, did not worsen further income distribution. In fact, the average participation of workers in total income improved slightly between 1981 and 1988 (33 percent).

The prospects for the future evolution of income distribution and employment heavily depend on whether or not Argentina succeeds in resuming growth. This is so, because it seems improbable that the level of employment continues to increase as a consequence of a reduction in the overall productivity of the economy.

Given that the income elasticity of employment is about 0.5 percent and the labor supply is growing at a rate of 2 percent per year, *ceteris paribus*, the economy should grow at a rate of 4 percent per year in order to maintain the labor market in equilibrium.

IV. CONCLUSIONS

Marked short-run macroeconomic instability and stagnation rooted in the current account and in the government budget disequilibria have been the main features of the Argentine economy throughout the eighties. These disequilibria, in turn, were caused by both the exhaustion of the development strategy based on import substitution and the "locomotive-of-growth" role of the state and increased foreign indebtedness. The persistence of instability and the lack of growth over a long period, on the other hand, have induced other disruptive effects such as the dollarization of financial relationships and the shortening of economic contracts on both the real and the monetary sides of the economy (i.e. the consolidation of the high inflation regime). The most dramatic outcome of all these disadjustments was the hiperinflationary process that Argentina experienced between May and July of the present year.

In this context, in order to achieve economic growth in a way that produces rapid expansion of employment and better income distribution, it will be necessary to put deep structural reforms into practice. This is so because, as we have seen, self-sustaining growth can only be restored by sharply increasing both domestic saving and investment. However, the growth exercises performed have only shown the overall requirements of resources that are needed. Behind these figures there is a complete set of interrelationships of social, political and economic variables. This makes it very difficult to get the necessary consensus for a new development strategy.

Given that the two main sources of instability are the public and the external sectors, it is essential that there be some degree of success in attaining a sustainable equilibrium in the long run in those areas. With regard to the external sector this means that a growth program should obtain support from foreign creditors and multilateral organisms such as the IMF and The World

Bank for either a rescheduling of external commitments or a significant voluntary reduction of the foreign debt.

However, although such an agreement is a necessary condition, it is not sufficient. A significant effort at the domestic level has to be made in order to overcome the most perverse disequilibria in the economy's structure. In the first place, the incentive and trade regimes must be modified in order to foster exports and to permit an increment of imports. In the second place, the public sector must introduce sharp changes in both the tax structure and the composition of its expenditures. The reform of the tax regime should fulfill three objectives: improve equity, increase the tax burden and remove distortions in relative prices. In order to do this, one of the most important tasks is that of reducing the participation of indirect taxes in tax collecting while increasing the proportion of direct taxes. With regard to expenditures, both investment and social services should benefit from the reallocation of funds while subsidies to production activities should be sharply cut. This is specially so with those subsidies that took the form of tax exemptions and public enterprises' underpricing policies. In the third place, a new structure of incentives for the private sector designed to revert the denationalization of savings and to increase investment should be implemented. The removal of the distortions in the financial system and deregulation and privatization policies will play a significant role here. The latter, however, should prevent the privatization of public monopolies so as to convert them in private ones.

The reform of the economic structure implies that the policy-maker will have to handle several key macroeconomic variables at the same time and the authorities will not be able to do so if macroeconomic instability in the short run is not removed. That is, the implementation of a growth package will not be possible without a stabilization program that significantly reduces the inflation rate and financial fragility.

TABLE I

	e	u	g	ig	sg	sp	dig	deg	det	i			
1987	7.60	97.80	0.16	6.30	8.60	5.20	-1.70	8.60	13.30	59.40	67.47	72.70	12.10
1988	11.50	97.80	0.45	7.05	6.30	3.60	0.75	8.89	19.94	62.72	70.52	78.66	13.23
1989	11.85	97.80	0.32	6.71	6.64	3.77	0.07	8.89	18.76	66.28	73.68	85.04	12.71
1990	12.20	97.80	0.16	6.31	6.60	3.53	-0.25	8.89	21.80	69.70	76.70	91.49	12.12
1991	12.57	97.80	0.01	5.91	6.53	3.27	-0.62	8.89	25.05	72.96	79.59	98.02	11.51
1992	12.94	97.80	-0.16	5.48	6.36	2.90	-0.88	8.89	28.56	75.98	82.28	104.54	10.28
1993	13.35	97.80	-0.33	5.05	6.08	2.40	-1.05	8.89	32.31	78.64	84.66	110.92	10.22
1994	13.73	97.80	-0.51	4.59	5.59	1.67	-1.00	8.89	36.42	80.75	86.50	117.15	9.53
1995	14.14	97.80	-0.67	4.12	5.11	0.96	-0.99	8.89	40.82	82.28	87.83	123.10	8.82
1996	14.57	97.80	-0.80	3.64	4.92	0.54	-1.28	8.89	45.56	82.38	89.93	129.14	8.12
1997	15.00	97.80	-1.09	3.13	4.62	-0.01	-1.47	8.89	50.68	84.52	89.68	138.20	7.37
1998	15.46	97.80	-1.27	2.64	4.38	-0.51	-1.74	8.89	56.21	85.16	90.27	147.66	6.60
1999	15.72	97.80	-1.48	2.10	4.11	-1.04	-2.00	8.89	62.20	85.44	90.27	157.66	5.80
2000	16.40	97.80	-1.49	1.54	3.81	-1.62	-2.26	8.89	68.69	85.39	90.06	154.08	4.97

TABLE II

	e	u	g	ig	sg	sp	dig	deg	det	i			
1987	7.60	97.80	0.16	6.30	8.60	5.20	-1.70	8.60	13.30	59.40	67.47	72.70	12.10
1988	11.50	97.80	0.46	7.07	6.33	3.62	0.74	8.89	18.95	62.74	70.54	78.69	13.25
1989	11.85	100.00	3.00	13.58	5.61	5.36	7.97	9.69	15.73	66.19	73.40	81.92	23.92
1990	12.20	100.00	3.00	13.58	5.43	5.18	8.16	9.69	15.52	69.34	75.97	81.86	23.02
1991	12.57	100.00	3.00	13.58	5.20	4.75	8.38	9.69	15.32	72.16	78.25	87.48	23.02
1992	12.94	100.00	3.00	13.58	4.86	4.61	8.73	9.69	15.12	74.56	80.17	87.68	23.02
1993	13.33	100.00	3.00	13.58	4.38	4.13	9.20	9.69	14.95	76.61	81.60	71.34	23.02
1994	13.73	100.00	3.00	13.58	3.69	3.44	9.87	9.69	14.74	77.52	82.33	92.26	23.02
1995	14.14	100.00	3.00	13.58	3.00	2.75	10.58	9.69	14.53	77.91	82.37	92.47	23.02
1996	14.57	100.00	3.00	13.58	2.58	2.33	11.00	9.69	14.39	77.87	82.00	92.75	23.02
1997	15.00	100.00	3.00	13.58	2.03	1.78	11.55	9.69	14.22	77.27	81.10	91.47	23.02
1998	15.46	100.00	3.00	13.58	1.52	1.27	12.06	9.69	14.05	76.19	79.75	90.24	23.02
1999	15.72	100.00	3.00	13.58	0.56	0.72	12.62	9.69	13.89	74.58	77.86	68.47	23.02
2000	16.40	100.00	3.00	13.58	0.36	0.11	13.22	9.69	13.74	72.42	75.45	86.45	23.02

SOURCE: Fanelli et al. (1989).

e: exports; u: activity level; g: gross rate; ig: public investment; sg: fiscal deficit; sp: foreign saving; sg: government saving; sp: private saving; dig: government domestic debt; deg: government foreign debt; det: total foreign debt; dig: total government debt; i: investment. All variables are expressed as proportions of the potential output.

INFLATION AND GDP

TABLE III
 (Annual growth rates in percentage)

Year	Inflation	GDP	Agriculture	Industry
1971	34.7	5.76	1.57	6.14
1972	58.4	2.08	1.92	4.02
1973	60.3	3.74	10.71	3.97
1974	24.2	5.41	2.73	5.87
1975	182.8	-0.59	-2.75	-2.55
1976	444.1	-0.01	4.53	-3.03
1977	176.0	6.38	2.46	7.81
1978	175.5	-3.22	2.82	-10.52
1979	159.5	7.02	2.82	10.19
1980	100.8	1.53	-5.51	-3.79
1981	104.5	-6.71	1.93	-15.98
1982	164.8	-4.98	6.92	-4.73
1983	343.8	2.93	1.89	10.81
1984	626.7	2.46	3.57	4.03
1985	672.2	-4.38	-2.57	-10.51
1986	90.1	5.38	-2.79	12.88
1987	131.3	2.00	3.40	-0.57
1988	342.9	-2.80	0.20	-6.80

SOURCE: BCRA and INDEC.

TABLE IV
 Balance of Payments
 (current million dollars)

Year	Trade Surplus	Financial Services Surplus	Current Account Surplus
1970	79.1	-222.5	-158.9
1971	-127.7	-255.9	-388.7
1972	36.4	-333.6	-222.9
1973	1036.5	-394.4	720.7
1974	295.8	-333.3	127.2
1975	-985.2	-429.6	-1284.6
1976	883.1	-492.5	649.6
1977	1409.3	-578.5	1289.9
1978	2565.8	-680.8	1833.6
1979	1109.9	-920.0	-536.4
1980	-2519.2	-1531.4	-4767.8
1981	-287.0	-3699.7	-4714.0
1982	2286.8	-4718.5	-2657.7
1983	3320.0	-5407.9	-2437.5
1984	3523.0	-5712.0	-2390.9
1985	4351.0	-5305.0	-952.8
1986	1955.0	-4416.0	-2859.0
1987	257.0	-4485.0	-4236.0
1988	3550.0	-5181.0	-1631.0

SOURCE: BCRA.

TABLE V
Foreign Debt (Million dollars)

Period	External Debt		
	Total	Public	Private
1975	7.875	4.021	3.854
1976	8.279	5.189	3.090
1977	9.678	6.044	3.634
1978	12.896	8.255	4.139
1979	19.034	9.960	9.074
1980	27.162	14.459	12.703
1981	35.671	20.024	15.647
1982	43.634	28.616	15.018
1983	45.069	31.709	13.360
1984	46.903	36.139	10.764
1985	49.326	39.868	8.444
1986	51.422	44.000	7.400
1987	54.700	nd	nd
1988	57.000	nd	nd

SOURCE: BCRA.

TABLE VI
Fiscal Deficit
(as a proportion of GDP)

Year	Deficit
71-75	8.2
76-80	7.5
81-85	12.5
86	4.1
87	7.4
88	4.2

SOURCE: SECRETARÍA DE HACIENDA.

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